86-844

No.

Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

LLOYD E. and LOIS B. DARLAND, *Appellants,*

v.

COMPTROLLER OF THE TREASURY, INCOME TAX DIVISION, STATE OF MARYLAND, *Appellee.*

On Appeal from the Court of Special Appeals of Maryland

JURISDICTIONAL STATEMENT *and* APPENDIX

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QUESTION PRESENTED

Are the Darlands entitled to refunds of all Maryland income taxes paid in 1979 and 1980, because the only income they received in those years was in the form of Federal Reserve Notes, which are statutory obligations of the United States at that time exempt and immune from all forms of state taxation?

The Court of Special Appeals of Maryland held that the answer to this question is "No". The Darlands submit that the answer is "Yes".

PARTIES TO THIS PROCEEDING

The caption of this case contains the names of all parties to the proceeding in the Court of Special Appeals of Maryland, the judgment of which the Darlands request this Court to review.

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On Appeal from the Court of Special Appeals of Maryland

JURISDICTIONAL STATEMENT

Lloyd E. and Lois B. Darland respectfully appeal from the judgment of the Court of Special Appeals of Maryland in *Darland* v. *Comptroller of the Treasury,* No. 53 (20 May 1986).

OPINIONS BELOW

The opinion of the Court of Special Appeals of Maryland of which the Darlands seek review is unreported, and is reprinted in the Appendix (App.) hereto at 3a. The opinion of the Circuit Court for Harford County, Maryland, which the Court of Special Appeals affirmed, is unreported, and is reprinted in App. at 9a. The order of the Court of Appeals of Maryland, denying the Darlands' petition for a writ

of certiorari to the Court of Special Appeals is unreported, and is reprinted in App. at 15a.

JURISDICTION

This is an appeal from a decision of the Court of Special Appeals of Maryland which sustained the imposition of 1979 and 1980 Maryland income taxes against the Darlands over their assertion that their income for those years consisted wholly of statutory obligations of the United States, at that time exempt and immune from all forms of state taxation perforce of federal law. The Court of Special Appeals rendered its decision on 20 May 1986. The Court of Appeals denied the Darlands' petition for a writ of certiorari on 22 August 1986. The Darlands filed their notice of appeal in the Court of Special Appeals on 18 November 1986.[1] This Court has appellate jurisdiction under 28 U.S.C. §§ 1257(2) and 2101(c), and under Rules 10 and 12 of the Rules of this Court.

STATUTORY PROVISIONS INVOLVED

The statutes involved in this appeal are 31 U.S.C. §§ 425, 742, and 5154, and Maryland Code art. 81, § 280(c)(1).[2]

STATEMENT OF THE FACTS

This case arose out of 1979 and 1980 Maryland income-tax assessments the Comptroller levied against the Darlands. Because of the evidence the Darlands presented, the Comptroller withdrew the assessments, leaving as the sole issue the Darlands' claims for re-

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[1] App. at 19a.

[2] The text of these statutes appears in App. at 25a.

funds of all taxes paid, arising out of amended tax-returns they filed.

In the Maryland Tax Court, Lloyd Darland testified without contradiction that during 1979 and 1980 the Darlands received only Federal Reserve Notes (FRNs) and checks convertible into FRNs. Darland testified that both he and his wife routinely deposited all personal checks in an account from which checks were drawn and converted into FRNs only; and that neither he nor his wife knew of any way to redeem these FRNs unit for unit for dollars of silver or gold, or for paper certificates redeemable in such dollars. The bank in which the Darlands deposited their checks, Darland stated, is a member-bank of the Federal Reserve System.

Also admitted without objection was the deposition of non-party expert witness Robert D. McTeer, Jr., Senior Vice-President of the Baltimore branch of the Federal Reserve Bank of Richmond, Virginia. McTeer testified that an FRN is not itself a dollar (or multiple thereof), but instead "is a form of a claim on a dollar", which under "recognized banking practice in the Federal Reserve Bank" can be exchanged only for "another claim", and is not redeemable in silver or gold dollars.

On this record, the Darlands demanded full refunds of all taxes paid, because:

1. Their incomes consisted only of FRNs or checks convertible into such notes alone.

2. FRNs are obligations of the United States government.

3. FRNs are not redeemable in silver or gold dollars. And,

4. Both Maryland law and then-applicable federal law exempted such irredeemable obligations of the United States from income-taxation by the State.

The Tax Court denied the Darlands' requests for refund, without opinion. On appeal, the Circuit Court for Harford County affirmed, relying on the earlier decision of the Court of Special Appeals in *Provenza* v. *Comptroller,* 64 Md. App. 563, 497 A.2d 831 (1985). The Court of Special Appeals then affirmed the Circuit Court, on four interconnected grounds:

1. "[T]he term 'obligations of the United States' as used in 28 [*sic,* no doubt '31' was meant] U.S.C. § 3124 (31 U.S.C. § 742 during the years here involved) and Md. Ann. Code art. 81, § 280(c)(1) refers to interest bearing instruments such as United States bonds and not to Federal Reserve Notes used as currency".

2. "[I]rredeemability into gold or silver coin is [not] the determining factor for tax-exempt status under either of [those] statutes".

3. "[T]he Maryland income tax is not on the federal obligation or note but rather on the income that is measured by the note". And,

4. The Darlands' "argument, if accepted, would have the absurd effect of preventing state taxation of any income which may be received in Federal Reserve Notes".[3]

The Court of Appeals denied the Darlands' petition for a writ of certiorari. The Darlands now seek this Court's review, and reversal, of the decision of the Court of Special Appeals.

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[3] App. at 6a.

SUBSTANTIALITY OF THE QUESTION PRESENTED

Since the early 1800's, obligations of the United States have been immune from state taxation, perforce of the United States Constitution or congressional statute. For the tax years 1979 and 1980, the applicable national law, 31 U.S.C. § 742, mandated that

> [e]xcept as otherwise provided by law, all stocks, bonds, treasury notes, *and other obligations of the United States*, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax.[4]

FRNs, the sole income the Darlands received in those years, are explicitly defined by statute as "obligations of the United States",[5] and therefore undeniably come within section 742. Notwithstanding, the Comptroller improperly "considered" these notes, "directly or indirectly, in the computation of the [Darlands' income] tax" for those years, in violation of section 742 yet (supposedly, according to the Court of Special Appeals) perforce of section 280(c)(1) of article 81 of the Maryland Code, which defines as "[a]mounts to be subtracted from federal adjusted gross income" all

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[4] Emphasis supplied. Amendments to the United States Code enacted after 1980 explicitly permit state income-taxation of FRNs. *See* 31 U.S.C. § 5154, *first enacted in* Act of 13 September 1982, Pub. L. 97-452, 96 Stat. 2477. *See also* 31 U.S.C. § 3124(a). The original section 742 applies in this case, however. *See* American Bank and Trust Co. v. Dallas County, 463 U.S. 855, 859 n.1 (1983).

[5] 12 U.S.C. § 411.

"income * * * exempt from State income taxes under the laws of the United States". The Comptroller's procedure being invalid on its face under federal statutory law, and the Court of Special Appeals' rationalization of this procedure being both legally and logically indefensible, the Darlands are entitled to a refund of all taxes paid for the years 1979 and 1980.

I. During the tax years 1979 and 1980, irredeemable currency that qualified as "obligations of the United States" was immune from state taxation under 31 U.S.C. § 742.

As early as 1829, in *Weston* v. *City of Charleston,* the United States Constitution was held to disable the States from taxing "the evidence of a debt created by the exercise of [Congress'] power" to borrow money on the credit of the United States.[6] Subsequently, this Court re-affirmed the holding and reasoning of *Weston* on numerous occasions.[7]

Under the *Weston* doctrine, the basic constitutional immunity from state taxation for obligations of the national government obtains even if Congress does not explicitly declare such an exemption.[8] But Congress may extend that immunity, or grant an immunity the Constitution itself does not confer, by statute.[9]

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[6] 27 U.S. (2 Pet.) 449, 465 (1829).

[7] *E.g.*, New York *ex rel.* Bank of Commerce v. Commissioners of Taxes, 67 U.S. (2 Black) 620, 631-35 (1862); Home Savings Bank v. City of Des Moines, 205 U.S. 503, 513-14 (1907).

[8] Plummer v. Coler, 178 U.S. 115, 118 (1900).

[9] United States v. City of Detroit, 355 U.S. 406, 474-75 (1958).

Where paper currency is concerned, Congress initiated statutory immunity from state taxation with the very first issue of legal-tender United States Notes in 1862, by providing that

> all stocks, bonds, *and other securities of the United States* held by individuals * * * within the United States, shall be exempt from taxation by or under State authority.[10]

Because this Court squarely held that legal-tender Treasury Notes were "securities of the United States", the latter statutory immunity directly applied, *even though the notes did* NOT *bear interest and Congress had issued them as a form of paper money that for many years constituted the main circulating currency of the county.*[11] Congress enacted similar laws in 1863, 1864, and 1865.[12] Ultimately, Congress embodied the immunity from state taxation in 31 U.S.C. § 742, quoted above.[13] The latter statute, as last amended

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[10] Act of 25 February 1862, ch. XXXIII, § 2, 12 Stat. 345, 346 (emphasis supplied).

[11] *See* Bank of New York v. Board of Supervisors, 74 U.S. (7 Wall.) 26 (1869), *especially at* 29-30. Given *Weston*, this decision was hardly anomalous, in as much as this Court sustained the emission of legal-tender Treasury Notes as an exercise of Congress' power to borrow. *See* Knox v. Lee, 79 U.S. (12 Wall.) 457, 560-61 (1871) (Bradley, J., concurring).

As explained in detail below, *Bank of New York* alone compels reversal of the Court of Special Appeals. *See post*, notes 15-17 & accompanying text.

[12] Act of 3 March 1863, ch. LXXIII, § 1, 12 Stat. 709, 710; Act of 30 June 1864, ch. CLXXII, § 1, 13 Stat. 218, 218; Act of 28 January 1865, ch. XXII, § 1, 13 Stat. 425, 425.

[13] *See* Society for Savings v. Bowers, 349 U.S. 143, 144 (1955).

in 1959, applies to the tax years 1979 and 1980.[14]

Pursuant to these statutory immunities, in the late 1800's this Court repeatedly treated United States Notes as exempt from state taxation.[15] The seminal opinion in *Bank of New York* v. *Board of Supervisors,* upholding the immunity from taxation of *non-interest-bearing notes intended to circulate as money,* is particularly instructive here, in as much as it utterly explodes the Court of Special Appeals' notion that FRNs (the modern-day successors to United States Notes) are taxable because they are not "interest bearing instruments such as United States bonds" but are "used as currency".[16] To the contention that United States Notes "were issued as money; that their controlling quality was that of money, and that therefore they were subject to taxation in the same manner, and to the same extent, as coin issued [by Congress]", the Court in *Bank of New York* responded that

> there is certainly much force in the argument. It is clear that these notes were intended to circulate as money, and * * * to constitute the credit currency of the country.
>
> Nor is it easy to see that taxation of these notes, used as money, and held by individual owners,

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[14] *Compare* Act of 22 September 1959, Pub. L. 86-346, § 105(a), 73 Stat. 621, 622, *with* American Bank and Trust Co. v. Dallas County, 463 U.S. 855, 859 n.1 (1983).

[15] Bank of New York v. Board of Supervisors, 74 U.S. (7 Wall.) 26, 29-31 (1869); Mitchell v. Board of Commissioners, 91 U.S. 206, 206-08 (1875); Canal & Banking Co. v. City of New Orleans, 99 U.S. 97, 97 (1878); Shotwell v. Moore, 129 U.S. 500, 594-95 (1888).

[16] App. at 6a.

can control or embarrass the power of the government in issuing them for circulation, more than like taxation embarrasses its power in coining and issuing gold and silver money for circulation.

Apart from the quality of legal tender impressed upon them by acts of Congress * * *, their circulation as currency depends on the extent to which they are received in payment, on the quantity in circulation, and on the credit given to the promises they bear. In these respects they resemble the bank notes formerly issued as currency.

But, on the other hand, it is equally clear that these notes are obligations of the United States. Their name imports obligation. Every one of them expresses upon its face an engagement of the nation to pay to the bearer a certain sum. The dollar note is an engagement to pay a dollar * * *.

* * * [W]e think it clearly within the discretion of Congress to determine whether, in view of all the circumstances attending the issue of the notes, their usefulness, as a means of carrying on the government, would be enhanced by exemption from taxation; and within the constitutional power of Congress * * *.[17]

In 1894, however, Congress limited the immunity of *currency*-notes by a statute ultimately codified in 31 U.S.C. § 425:

Circulating notes of national banking associations and United States legal tender notes and other notes and certificates payable on demand and circulating or intended to circulate as currency and gold, silver, or other coin shall be subject to tax-

[17] 74 U.S. (7 Wall.) at 30 (emphasis supplied).

> ation as money on hand or on deposit under the laws of any state * * *.[18]

Significantly, though, *as of and after 1894, all "United States legal tender notes" and other currency were "payable on demand" in United States gold or silver coin,*[19] *as were all notes of "national banking associations" (including, after 1913, the Federal Reserve System) and "other notes and certificates of the United States"*—until Congress terminated redemption of paper currencies in gold (1933) and in silver (1968).[20]

Thus, as of 1979 and 1980 (the only tax-years in issue here), under sections 425 and 742 all forms of paper money "circulating or intended to circulate as currency" that qualified as "obligations of the United States" were exempt from taxation by the States, *except where "payable on demand"*. And no such cur-

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[18] Act of 13 August 1894, ch. 281, 28 Stat. 278. *See* Smith v. Davis, 323 U.S. 111, 114 n.4 (1944). Congress amended section 425 in 1982, to provide that "[a] State * * * may tax United States coins and currency (including Federal Reserve Notes and circulating notes of Federal Reserve Banks and national banks) as money on hand or on deposit". Act of 13 September 1982, Pub. L. 97-452, § 5154, *now* 31 U.S.C. § 5154.

[19] *See* Act of 14 January 1875, ch. 15, § 3, 18 Stat. 296, 296. With the passage of this Act, United States legal-tender Treasury Notes became the equivalent of gold and silver coin. Conversely, from 1862 until 1875, these notes had been *irredeemable* in gold or silver, just as FRNs are today.

[20] *See for gold:* Act of 9 March 1933, ch. 1, 48 Stat. 1; H.J. Resolution No. 192, 5 June 1933, ch. 48, 48 Stat. 112; Act of 30 January 1933, ch. 6, 48 Stat. 337. *See for silver:* Act of 24 June 1967, Pub. L. 90-29, 81 Stat. 77. For the complete history, *see* E. Vieira, Jr., *Pieces of Eight: The Monetary Powers and Disabilities of the United States Constitution* (1983), at 237-333.

rencies "payable on demand" were then in existence, Congress having terminated redemption of FRNs in gold in 1933, and in silver in 1968. This history demolishes the Court of Special Appeals' *ipse dixit* that "irredeemability into gold or silver is [not] the determining factor for tax-exempt status [of FRNs]".[21] To the contrary: the clear record of the paper-currency and tax statutes of the country shows beyond any possible doubt that Congress has said exactly the opposite.

II. During the tax years 1979 and 1980, the Federal Reserve Notes the Darlands received as income were statutory "obligations of the United States", but were not "payable on demand" in silver or gold coin, and therefore were exempt from Maryland income taxation.

During 1979 and 1980, congressional statute explicitly provided (as it provides today) that FRNs are "obligations of the United States".[22] Consequently, FRNs were then exempt from

> every form of taxation [by the State of Maryland] that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax[,][23]

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[21] App. at 6a.

[22] 12 U.S.C. § 411.

[23] 31 U.S.C. § 742. This section does allow States to levy "nondiscriminatory franchise or other nonproperty taxes in lieu thereof [to be] imposed on corporations". But that permission is irrelevant here, because the Darlands did not conduct their businesses or receive any income through a corporation, or as the result of some franchise granted by the State.

unless—*and only unless*—they came within the statutory permission for state taxes on currency "payable on demand".[24] Since 1933 and 1968 respectively, however, FRNs have *not* been "payable on demand" (that is, redeemable) in gold or silver coin.[25] They were not so "payable" either in 1979 and 1980, or today.[26] Therefore, in 1979 and 1980 FRNs were absolutely immune from any form of Maryland taxation. *And the Court of Special Appeals cited* NO AUTHORITY WHATSOEVER *(other than its own earlier, and patently erroneous* Provenza *decision) for the contrary proposition.*

Because, undisputedly, the only income the Darlands received in 1979 and 1980 consisted of FRNs (or checks cashable in such notes alone), the Darlands' income was wholly exempt from Maryland income-taxation in those years, perforce of then-applicable congressional statute and this Court's decisions.

III. The Darlands are entitled to refunds of taxes paid in 1979 and 1980, because the Comptroller improperly "considered" their tax-exempt income in Federal Reserve Notes in the computation of their taxes.

Taxation of "income" is not exempt from the general prohibition against States' taxing obligations of

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[24] 31 U.S.C. § 425.

[25] *See ante,* note 20. *See also* as to the present (or *post*-1968) situation the testimony of Robert D. McTeer, Jr., quoted *ante,* p. 3.

[26] *See* the then-applicable code provisions 31 U.S.C. §§ 315(b), 408(a), *and* 408a-3; and the contemporary code provisions (amended in 1982) 31 U.S.C. §§ 5118(b) and 5119(a, b).

the United States.[27] As a tax on "income" taxes the things that constitute the income, a tax on income received in FRNs taxes those notes and those notes alone—indeed, is actually *paid in those very notes*—and thus physically, as well as logically and legally, necessarily taxes "obligations of the United States".[28]

The Court of Special Appeals' rationalization that "the Maryland income tax is not on the federal obligation or note but rather on the income that is measured by the note" is simply double-talk.[29] When a person's income accrues solely in the form of federal obligations, and those obligations are simultaneously the major circulating currency of the country (as were FRNs in 1979 and 1980, even as they are today), then

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[27] *See* Northwestern Ins. Co. v. Wisconsin, 275 U.S. 136, 140 (1927); and *mutatis mutandis* Farmers and Mechanics Savings Bank of Minneapolis v. Minnesota, 232 U.S. 516, 526-27 (1914). Thus, *pace* the Court of Special Appeals, there is nothing at all "absurd" about the contention that a tax-immunity applied to income received in FRNs in the tax-years 1979 and 1980. The only issue, which the Court of Special Appeals failed to address, is whether Congress mandated such an immunity in those years, as evidenced by the statutes then in force.

[28] *Compare* Dobbins v. Erie County, 41 U.S. (16 Pet.) 435, 445-46 (1842) ("Taxes are never assessed * * * upon persons, as persons, but upon them on account of their goods * * *. The goods, then, are taxed, and not the person."), *with, e.g.*, Bank Tax Case, 69 U.S. (2 Wall.) 200, 208-09 (1864) (tax on "capital" of bank invested in obligations of the United States amounts to tax on the obligations themselves). Here, the taxes imposed on the Darlands were levied on "their goods", which consisted of FRNs; and on their "income", which was composed of "obligations of the United States" in the same way the "capital" of the bank in the *Bank Tax Case* was so composed.

[29] App. at 6a.

a tax upon that income is necessarily a tax upon the obligations themselves. For, beyond question, the State seizes a portion of the obligations to satisfy a liability that arises from the mere receipt of, and is measured by the receipt of, those very obligations. Where the things received as income and the things used as a measure (not to mention the means of payment) of the tax are identical, and are both federal obligations, it is logically impossible to separate the act of "measuring" income (or calculating the tax thereon) according to the amount of notes the taxpayer received, from the act of seizing some or all of the obligations themselves because of the taxpayer's receipt of them.

Moreover, according to the Court of Special Appeals' Alice-in-Wonderland reasoning, Maryland may also impose an "income" tax upon the interest received from interest-bearing federal obligations, even though that court conceded that these obligations are wholly exempt from tax. Indeed, according to the Court of Special Appeals, Maryland may even fix an "income" tax on the receipt of interest-bearing federal obligations themselves. For, in each case, if the interest were paid in FRNs, or the value of the interest or the obligations themselves denominated in such notes, the State could claim that the "tax is not on the federal obligation", but only on the "income that is measured by the note[s]"! That the logically inevitable result of the Court of Special Appeals' theory flies in the face of the very principles of federal law that that court concedes apply in this case compels rejection of the theory.

That Maryland has indiscriminately taxed the Darlands' tax-exempt income is, of course, a consequence

of the mechanical procedure the State uses to calculate income taxes:

> [T]he whole thrust of the Maryland [income-tax law] is to impose a tax on the amount determined under the Internal Revenue Code [of the national government] as the adjusted gross income of an individual * * *. This is a formula * * * *which initially takes no account of the source, nature o[r] composition of the funds; it is simply a figure developed by the federal return.*[30]

As amended in 1959, 31 U.S.C. § 742 absolutely disallowed this procedure: "Under the plain language of the 1959 amendment, * * * the [state] tax is barred regardless of its *form* if federal obligations must be *considered, either directly or indirectly,* in *computing* the tax".[31] Moreover, "[t]he language of § [742] encompasses 'every form of taxation,' and is inconsistent with implied exceptions".[32] Thus, section 742 required the Comptroller to *dis*regard the value of the Darlands' FRN receipts in calculating their taxable income, *not* to include that value in computing their assessments, and to attribute *no* tax burden to their ownership of those notes.[33]

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[30] Comptroller of the Treasury v. Chesapeake Corporation of Virginia, 54 Md. App. 208, 213, 458 A.2d 459, 463 (1983) (emphasis supplied).

[31] American Bank and Trust Co. v. Dallas County, 463 U.S. 855, 862 (1983) (emphasis supplied).

[32] *Id.* at 864.

[33] *See* Missouri *ex rel.* Missouri Ins. Co. v. Gehner, 281 U.S. 313, 320-22 (1930); New Jersey Realty Title Ins. Co. v. Division of Tax Appeals, 338 U.S. 665, 670-75 (1950); Farmers and Mechanics Savings Bank of Minneapolis v. Minnesota, 232 U.S. 516, 528 (1914).

Because the Comptroller proceeded in the opposite fashion, the Darlands' 1979 and 1980 tax liabilities are void; and they are entitled to refunds.

IV. The Court of Special Appeals' decision in *Provenza* is erroneous on its face, because it does not take into account the irredeemability of Federal Reserve Notes.

The Court of Special Appeals ruled against the Darlands solely on the "authority" of *Provenza* v. *Comptroller*[34] and its holding that FRNs are taxable because they are not "interest bearing instruments such as United States bonds", and because the notes' "irredeemability into gold or silver coin is [not] the determining factor for tax-exempt status".[35] As explained above, however, the factor determining the tax-exempt nature of FRNs between 1968 and 1982 (as it had been with legal-tender United States Notes between 1862 and 1894) was *not* their non-existent "interest-bearing" character, but precisely their irredeemability in gold or silver coin. *Provenza's* misreading of legal history, then, could not be more glaring.

Moreover, in support of its errant conclusion *Provenza* cited two opinions of this Court—or, perhaps more descriptively, *miscited* those opinions. For both of these decisions completely support the position the Darlands assert here. In *Smith* v. *Davis,* this Court held that "[31 U.S.C. § 742] on its face applies only to written interest-bearing obligations". But it justified its conclusion by noting that

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[34] 64 Md. App. 563, 497 A.2d 831 (1985).

[35] App. at 6a.

> [t]he only Treasury notes that could be included within [§ 742] are interest-bearing ones, *in light of the provisions of * * * 31 U.S.C. § 425, allowing notes and certificates payable on demand and circulating as currency to be taxed by the states.*[36]

Thus, *Smith* confirms the Darlands' contention that section 742 must be read in conjunction with section 425, and that, where section 425 does *not* confer an exception on some currency-"obligation" within section 742 *in haec verba,* no exception exists. That is, where the "notes * * * circulating as currency" are *not* "payable on demand" (as FRNs were not in 1979 and 1980), the *Smith* limitation of tax-exempt status to "interest-bearing" notes is inapplicable—and, indeed, *Smith* stands for the proposition that such currency-"obligations" *not* "payable on demand" *are* tax-exempt.

Then, in *Memphis Bank & Trust Co.* v. *Garner* (the second decision on which *Provenza* incautiously relied), this Court held in the broadest possible terms that

> [a] state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations.[37]

Here, *ex necessitate,* a state tax on FRNs "impermissibly discriminates against federal obligations", because Article I, Section 10, Clause 1 of the Constitution absolutely prohibits a State from emitting paper

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[36] 323 U.S. 111, 116 & n.6 (1944) (emphasis supplied). In 1944, FRNs *were* "payable on demand" dollar-for-dollar in silver coin.

[37] 459 U.S. 392, 397 (1983).

money ("Bills of Credit"). If FRNs were redeemable in silver or gold coin, a state tax on the notes could be seen as equivalent to a tax on the coin, which has always been proper, in as much as coin is not an "obligation", but the medium of payment of all "obligations" denominated in monetary units. As the notes are not redeemable, however, no rational basis exists for equating taxation of them with taxation of coin. And, therefore, *Memphis Bank* compels a holding in the Darlands' favor.

Finally, the fear expressed in *Provenza* (and reiterated by the Court of Special Appeals in this case) that the Darlands' "argument, if accepted, would have the absurd effect of preventing state taxation of any income which may be received in Federal Reserve Notes"[38] is both irrelevant and groundless. The Darlands' extensive review of the statutory and decisional history of the tax exemption for federal currency that is simultaneously an "obligation of the United States" demonstrates that, if accepting their argument "would have [an] absurd effect", the "absurdity" must be attributed to the United States Constitution, Congress, and this Court, not to the Darlands. Moreover, in 1982 Congress amended 31 U.S.C. § 425, the amendment being codified at 31 U.S.C. § 5154. In that amendment, Congress substituted the words

> United States coins and *currency (including Federal Reserve Notes* and circulating notes of Federal Reserve Banks and national banks)

for the language in effect during 1979 and 1980, which read

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[38] App. at 6a.

> [c]irculating notes of national banking associations and United States legal tender notes *and other notes* and certificates *of the United States payable on demand and circulating or intended to circulate as currency* * * *.[39]

Thus, in 1982 Congress: (i) explicitly recognized that the States at that time had *no* authority to tax FRNs, precisely because those notes were no longer "payable on demand" after 1968; and (ii) took corrective action to permit taxation thereafter. Indeed, any other interpretation of this statutory change would be nonsensical. The effect of the 1982 amendment, though, is to *permit* state taxation of FRN income *after 1982* (that is, now and for the forseeable future), even as it recognizes that such taxation was illegal and void from 1968 until 1982.

V. The theory of state power to tax "obligations" of the national government that the Court of Special Appeals excogitated strikes at the very heart of Congress' monetary authority, and threatens to frustrate the exercise of that authority in any future monetary crisis.

The significance of this case lies not in the small amount of money the Darlands claim as tax refunds for 1979 and 1980 (less than $1,000), or in the small number of people besides the Darlands who could claim income-tax refunds in Maryland or other States on similar grounds (Congress having made FRN "obligations" fully taxable in 1982). Rather, it lies in the potential for creating monetary chaos that lurks in the Court of Special Appeals' aberrant notion that

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[39] Emphasis supplied.

Maryland—and, by extension, every other State or political subdivision thereof empowered to levy taxes—may, with impunity, tax non-interest-bearing "obligations" of the national government, particularly if those "obligations" function as a legal-tender currency.

History has witnessed Congress exercise its monetary authority to respond to national emergencies with the emission of United States "securities" or "obligations" intended to circulate as money and impressed with legal-tender character on two occasions: First, during the Civil War, Congress emitted non-interest-bearing United States Notes, irredeemable in silver or gold coin, that were simultaneously government "securities" (as this Court held in the *Bank of New York* case) and legal-tender currency. Second, during the Great Depression, Congress allowed the Federal Reserve System to emit non-interest-bearing Federal Reserve Notes, irredeemable in gold coin, that were simultaneously government "obligations" and legal-tender currency. (And later Congress mandated irredeemability of FRNs in silver coin, too.) At various times, Congress has also determined that these "securities" and "obligations" should not be taxable by the States, or should be taxable because "payable on demand" (31 U.S.C. § 425) or notwithstanding their irredeemability in silver or gold (31 U.S.C. § 5154). In any event, the power of Congress over the taxability by States of legal-tender currencies that are at once non-interest-bearing "securities" or "obligations" of the United States has always been held absolute and exclusive—*until the Court of Special Appeals determined in this case and its predecessor,* Provenza, *that Maryland may decide for itself whether such "securities" or "obligations" are taxable.*

Not only is the Court of Special Appeals' decision unprecedented, but also it strikes at the very heart of Congress' monetary authority. As the lessons of the Civil War and the Great Depression eloquently teach, the evolution of the national monetary system has been away from silver or gold coin, and from paper currencies redeemable in or otherwise based on specie, to money composed primarily (except for token coinage) of legal-tender government "obligations" that are both irredeemable in precious metal and non-interest-bearing. At the present time, these "obligations" take the form of Federal Reserve Notes, which the average person treats simply as "money", and which Congress determined in 1982 could be subject to state taxation. But, as this Court made clear in the *Bank of New York* case, the character of whatever instrument Congress emits as an "obligation" or "security" of the United States, and not its function as currency, determines its exposure to state taxation (absent explicit congressional permission therefor). The Court of Special Appeals' decision effectively sets this understanding on its head, by ruling that the practical monetary function of the instrument overrides its explicit statutory character as an "obligation" or "security" of the United States in so far as taxation is concerned. Thus, the Court of Special Appeals has provided Maryland, and other States so inclined, with a rationalization to undermine, if not to thwart outright, what has become since the Civil War the almost exclusive means to create money: the "monetization" of (or granting of legal-tender character to) "obligations" of the United States either directly, as by emission of United States Notes, or indirectly, as by the emission of Federal Reserve Notes attendant on the Federal Reserve System's purchase of government bonds.

The potential for monetary chaos arising out of the Court of Special Appeals' radical departure from the traditional understanding of Congress' authority is as great as the present domestic financial climate is foreboding. If a collapse of the American banking and currency systems is not certain, neither is it all that unlikely in the foreseeable future.[40] In a nationwide liquidity crisis, a successful national policy to secure economic recovery may require the immediate emission of a new legal-tender currency, the exchange-value of which in domestic markets Congress chooses to stabilize by declaring the currency a "security" or "obligation" of the United States, notwithstanding its non-interest-bearing character. In such circumstances of monetary stringency—from the rigors of which, presumably, the States and their subdivisions will not be immune—, the pressure to discover new sources of revenue could provoke state and local governments to adopt the perverse reasoning of the Court of Special Appeals in aid of comprehensive taxation of the new outflow of national paper currency, thereby *destabilizing* the precarious new national monetary system by *decreasing* the real exchange-value of the new currency to the extent of the burdens of state and local taxation. To be sure, Congress or this Court would at some later stage in the process intervene to outlaw such state or local action. But, in the press of economically catastrophic events, this intervention might come too late, only after state and local tax-schemes had had their baneful effects on the new issue of United States legal-tender "obligations", perhaps even destroying the potential of that issue to stem the tide of monetary collapse.

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[40] *See, e.g.*, A. U. Freemarket, *The Illusions of Prosperity* (1985).

Can this Court afford to assume that such a sequence of events will not occur in the not-too-distant future? Can it afford to assume that other state courts will not reach for the comforting rationale the Court of Special Appeals has supplied, if (or perhaps *when* is more accurate) they perceive the parochial economic needs of their States as more important than the national interest in delivering the American monetary system from destruction? Can it, in short, afford to assume that *what New York actually attempted to do* to the United State Notes of the Civil War, until this Court frustrated its designs in the *Bank of New York* case; and *what the Court of Special Appeals has successfully done* to Federal Reserve Notes, unless this Court stifles its pretensions in this case; States other than New York or Maryland will not venture to accomplish, too, when circumstances provide the opportunity? Indeed, can this Court pretend that the practical effect of the Court of Special Appeals' decision in this case is other than to set aside the rule of the *Bank of New York* case, and license Maryland now, and other States later on the strength of Maryland's success, to arrogate to themselves the power to decide what qualities render a "security" or "obligation" of the United States immune from state taxation—*and what qualities render it fully subject thereto?* And, if so, can this Court hope, let alone believe, that if sustained by default in this case the decision of the Court of Special Appeals will not effectively supersede the holding in *Bank of New York* in the eyes of other state courts?

But these questions answer themselves. And their answers emphasize even more than the merely legal demerits of the Court of Special Appeals' decision the pressing need for this Court to hear this appeal.

CONCLUSION

For the foregoing reasons, this Court should note probable jurisdiction of the Darlands' appeal.

Respectfully submitted,

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APPENDIX

OPINION OF THE COURT OF SPECIAL APPEALS OF MARYLAND UPON RENDERING THE JUDGMENT TO BE REVIEWED IN THIS APPEAL, 20 MAY 1986

(unreported)

UNREPORTED

IN THE COURT OF SPECIAL APPEALS OF MARYLAND

No. 53

September Term 1986

LLOYD E. DARLAND, ET UX.

v.

COMPTROLLER OF THE TREASURY

Gilbert, C.J.
Bishop
Bloom,
JJ.

PER CURIAM

Filed: May 20, 1986

The Maryland Tax Court denied Lloyd E. and Lois B. Darland's claims for refunds of income taxes paid for the years 1979 and 1980. The Darlands appeal the decision of the Circuit Court for Harford County which affirmed that denial.

FACTS

This appeal is under the Expedited Appeal process pursuant to Maryland Rule 1028. The agreed statement of facts provides:

1. This case arose out of 1979 and 1980 Maryland income-tax assessments the Comptroller levied against the Darlands. Because of evidence the Darlands presented, the Comptroller withdrew the assessments, leaving as the sole issue the Darland's claims for refunds of all taxes paid, arising out of amended tax returns they filed.

2. In the Tax Court, Lloyd Darland testified, that during 1979 and 1980 the Darlands received as income only "federal reserve notes and checks * * * convertible into federal reserve notes", and that the U.S. Treasury checks he "received" for his retirement "were converted [into] personal checks, subsequently converted into federal reserve notes".

3. Mr. Darland testified that both he and his wife "routinely deposited [all personal checks] in an account from which checks [were] written and converted into federal reserve notes" only. He testified that neither he nor his wife knew of any way for them to redeem these federal reserve [2] notes unit for unit for dollars of silver or gold, or for paper certificates redeemable in such dollars. The bank in which Darland deposited his government retirement is a member-bank of the Federal Reserve System. The Comptroller did not cross-examine Mr. Darland or call any other witness. Also admitted without objection was the deposition of non-party witness Robert D. McTeer, Jr., Senior Vice-President of the Baltimore branch of the Federal Reserve Bank of Richmond, Virginia. McTeer testified that a Federal Reserve Note is *not* itself a dollar (or multiple thereof), but instead "is a form

of a claim on a dollar," which under "recognized banking practice in the Federal Reserve Bank" can be exchanged only for "another claim," and is not redeemable in silver or gold dollars.

4. On this record, the Darlands demanded refunds of all taxes paid because:

a. Their incomes consisted only of Federal Reserve Notes or checks convertible into such notes;

b. Federal Reserve Notes are obligations of the United States Government;

c. Both Maryland law and then-applicable federal law exempted obligations of the United States Government from income taxation by the State; and

d. Federal Reserve Notes are not redeemable in silver or gold dollars.

5. The Tax Court denied the Darlands' request for refunds without opinion. The Darlands then appealed to the Circuit Court of Harford County which affirmed the Tax Court, relying on *Provenza v. Comptroller*, 64 Md. App. 563, 497 A.2d 831 (1985).

[3] DISCUSSION

Appellants' argument that federal and state statutory provisions prevent state taxation of their income because it was in or convertible to Federal Reserve Notes was rejected by our recent holding in *Provenza v. Comptroller*, 64 Md. App. 563, 567-68 (1985). Nevertheless, taking technical legal argument to the extreme, appellants attempt to distingiush *Provenza* on the grounds that in *Provenza* we failed to recognize that the determination factor for

tax-exempt status is the irredeemability of the notes into gold or silver coin. Appellants' argument is without merit.

We need not reach appellants' contentions because they are founded upon a fundamentally flawed premise. As made clear in *Provenza,* the term "obligations of the United States" as used in 28 U.S.C. § 3124 (31 U.S.C. § 742 during the years here involved) and Md. Ann. Code art. 81, § 280(c)(1) refers to interest bearing instruments such as United States bonds and not to Federal Reserve Notes used as currency. *Provenza,* 64 Md. App. at 658. We expressly reject the contention that irredeemability into gold or [4] silver coin is the determining factor for tax-exempt status under either of the statutes previously mentioned. Further, the Maryland income tax is not on the federal obligation or note but rather on the income that is measured by the note. As we noted in *Provenza,* appellants' argument, if accepted, would have the absurd effect of preventing state taxation of any income which may be received in Federal Reserve Notes. 64 Md. App. at 568. The judgment of the Circuit Court upholding the Tax Court's denial of a refund is affirmed.

JUDGMENT AFFIRMED;

COSTS TO BE PAID BY APPELLANTS.

ORDER AND OPINION OF THE CIRCUIT COURT FOR HARFORD COUNTY, MARYLAND, AFFIRMING THE DECISION OF THE MARYLAND TAX COURT, 12 NOVEMBER 1985

(unreported)

IN THE CIRCUIT COURT
FOR HARFORD COUNTY

Civil Action No. 1560

LLOYD E. DARLAND and LOIS B. DARLAND
Petitioners

vs

COMPTROLLER OF THE TREASURY
INCOME TAX DIVISION
Respondent

ORDER

The record in the above captioned case having been read and considered and all parties having had the opportunity to submit their position to the Court,

It is this 12th day of November, 1985, the decision of the Court that the decision of the Maryland Tax Court is hereby SUSTAINED.

/s/ William O. Carr
WILLIAM O. CARR Judge

IN THE CIRCUIT COURT
FOR HARFORD COUNTY

Civil Action No. 1560

LLOYD E. DARLAND and LOIS B. DARLAND
Petitioners

vs

COMPTROLLER OF THE TREASURY
INCOME TAX DIVISION
Respondent

MEMORANDUM OPINION

This matter is before the Court on the Plaintiff's appeal from the decision of the Tax Court. The issue to be decided is whether the Tax Court erred in denying the Plaintiffs a refund for 1979 and 1980.

The Plaintiffs contend that the Tax Court erred because it considered as part of the Plaintiffs' taxable income, income which was received in the form of Federal Reserve Notes. It is argued that since these notes are not redeemable for silver or gold, they constitute an obligation of the U.S. government and are therefore exempt from taxation under 31 U.S.C. 742 (now 31 U.S.C, Section 3124(a)).

This issue was recently decided by the Court of Special Appeals in Provenza v. Comptroller, 64 Md. App. 563 497 A.2d 831 (1985). The Court stated:

> The definition of Federal Reserve Notes as 'obligations of the United States' within the context of 12 U.S.C., Section 411 is clearly distinguishable **[2]** from the meaning used in 31 U.S.C., Section 3124 and Md. Ann. Code Art. 81, Section 280 (c)(1). Section 411 is contained within Title 12 of the United States Code which created the Federal Reserve System, and in

> which Federal Reserve Notes are defined as 'obligations of the United States.' The purpose behind this is to make clear that the notes are authorized currency of the United States. The term 'obligations of the United States' as used in 21 U.S.C. Section 3124 and Art. 81 of the Md. Code refers to interest bearing instruments such as United States bonds. See *Memphis Bank & Trust Co., v. Garner,* 459 U.S. 392, 395-96, 103 S.Ct. 692, 695-96, 74 L.Ed 2d 562 (1983); *Smith v. Davis,* 323 U.S. 111, 116-117, 65 S.Ct. 157, 160, 89 L.Ed 107 (1944).

Thus, the Federal Reserve Notes with which Appellants were paid are not "obligations of the United States" which are exempted from income tax pursuant to Article 81 of the Maryland Code.

No Petition for Certiorari has been filed in the *Provenza* case so it is at this time the law of the State of Maryland and binding upon this Court. *Deems v. Western Maryland Railway Company,* 247 Md. 95, (at p. 102), 231 A.2d 514 (1967).

[3] For these reasons, the decision of the Maryland Tax Court is hereby SUSTAINED.

/s/ William O. Carr
WILLIAM O. CARR Judge

November 12, 1985

ORDER OF THE COURT OF APPEALS OF MARYLAND, DENYING THE PETITION FOR A WRIT OF CERTIORARI, 22 AUGUST 1986

(unreported)

IN THE
COURT OF APPEALS OF MARYLAND

Petition Docket No. 247

September Term, 1986

(No. 53, September Term, 1986
Court of Special Appeals)

LLOYD E. DARLAND and LOIS B. DARLAND

v.

COMPTROLLER OF THE TREASURY,
INCOME TAX DIVISION

ORDER

Upon consideration of the petition for a writ of certiorari to the Court of Special Appeals and the answer filed thereto, in the above entitled case, it is

ORDERED, by the Court of Appeals of Maryland, that the petition be, and it is hereby, denied as there has been no showing that review by certiorari is desirable and in the public interest.

Judge Adkins did not participate in the consideration of this petition.

/s/ Robert C. Murphy
Chief Judge

Date: August 22, 1986

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES,

18 NOVEMBER 1986

No. 53

In The
COURT OF SPECIAL APPEALS OF MARYLAND
September Term 1986

LLOYD E. and LOIS B. DARLAND, *Appellants,*

v.

COMPTROLLER OF THE TREASURY, INCOME TAX DIVISION, *Appellee.*

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

[Received, Court of Special Appeals of Md.
1986 Nov 18 AM 8:41, H. E. Friedman, Clerk]

Notice is hereby given that Lloyd E. Darland and Lois B. Darland appeal to the Supreme Court of the United States from the final judgment of the Court of Special Appeals of Maryland entered in this action on 20 May 1986. The Court of Appeals of Maryland denied Appellants' petition for a writ of certiorari on 22 August 1986.

The decision of the Court of Special Appeals held that the term "obligations of the United States" as used in 28 U.S.C. § 3124 (31 U.S.C. § 742 during the years here involved) (i.e. 1979 and 1980) and Md. Ann. Code art. 81, § 280(c)(1) refers to interest bearing instruments such as United States bonds and not to Federal Reserve Notes used as currency; specifically rejected the contention that irredeemability into gold or silver coin is the determining

factor for tax-exempt status under either of the statutes previously mentioned; and that Maryland income tax is not on the federal obligation or note but rather on the income that is measured by the note. Appellants maintain that this decison is wrong in its entirety.

This appeal is taken pursuant to Title 28, United States Code, Section 1257(2).

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Notice of Appeal to the Supreme Court of the United States were delivered to:

The Clerk
Court of Special Appeals of Maryland
Annapolis, Maryland 21401-1698

and were mailed, first-class, postage prepaid, to:

The Clerk
Circuit Court for Harford County, Maryland
20 West Courtland Street
Bel Air, Maryland 21014

and to

GERALD LANGBAUM, ESQ.
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on this 18th day of November, 1986.

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TEXT OF STATUTORY PROVISIONS INVOLVED

31 United States Code § 425. State taxation.

Circulating notes of national banking associations and United States legal tender notes and other notes and certificates of the United States payable on demand and circulating or intended to circulate as currency and gold, silver, or other coin shall be subject to taxation as money on hand or on deposit under the laws of any State or Territory: Provided That any such taxation shall be exercised in the same manner and at the same rate that any such State or Territory shall tax money or currency circulating as money within its jurisdiction.

31 United States Code § 742. Exemption from taxation.

Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

31 United States Code § 5154. State taxation.

A State or territory or possession of the United States may tax United States coins and currency (including Federal reserve notes and circulating notes of Federal reserve banks and national banks) as money on hand or on deposit in the same way and at the same rate that the State, territory, or possession taxes other forms of money. This section does not affect a law taxing national banks.

Maryland Code art. 81, § 280(c)(1).

(c) *Amounts to be subtracted from federal adjusted gross income*—There shall be subtracted from federal adjusted gross income:

(1) Interest or dividends on obligations of the United States and its territories and possessions or of any authority, commission or instrumentality of the United States and any other income to the extent includable in gross income for federal income tax purposes, but exempt from State income taxes under the laws of the United States.